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UPDATE ON JAPAN'S VENTURE CAPITAL INDUSTRY: PROBLEMS AND PROMISES

Summary

Japan's venture capital industry has endured a depression since JEI's first report on this subject (JEI Report No. 39A, October 12, 1984) but is now on its way to recovery. The path out of the doldrums, however, has taken unexpected directions that mirror developments in the U.S. venture capital industry in some respects. Regulatory and cultural problems will continue to hamper venture capitalists and entrepreneurs in the Japanese market where they may never play the role they have in the United States. Nonetheless, venture capital is beginning to carve out a place for itself in Japan's economic framework, particularly in light of the nation's efforts to restructure.

Boom and Bust

By the early 1980s Japan's venture capitalists and entrepreneurs were poised for a take-off. Following the abortive "boom" of the early 1970s, the field had lain dormant. Under the impact of the computerization of Japanese businesses and homes and the development of new industries, such as biotechnology and structural ceramics, venture capitalists and entrepreneurs caught a wave of public interest in high technology industries between 1982 and 1985. Instead of a smooth ride to growth and profits, however, investors and businesses were battered about as the wave collapsed and reality set in.

The focus on high technology fields was a natural attempt to replicate the success of the U.S. venture capital industry. Many important American computer and software companies were born thanks to venture funds, and the two industries seem to be continually revitalized by innovative start-up firms.

Computer hardware and software firms, in particular, mushroomed in Japan between 1982 and 1985 in response to the growing demand from businesses and households. The boom also encompassed robotics, semiconductor manufacturing equipment, biotechnology, fiber optics and digital communications. These small firms initially were a success: they were more innovative than big companies, could produce custom products quickly and could respond to market changes with relative ease.

In spite of the continual deregulation and liberalization of Japan's domestic goods and financial markets, the long-term odds remained heavily stacked against start-up companies and their backers. Some of the factors derive from the strengths that big, established firms can bring to bear against competitors. Others arise from the structure and organization of the Japanese economy and society.

Research and development outlays - Investment in R&D is the lifeblood of high technology firms and is an area of sharp differences between small and large firms. Even if start-ups devote a very large share of their budget to new product development, the absolute amount is always dwarfed by the R&D budgets of the biggest Japanese companies. While big companies' inability to conduct research in all areas at once leaves windows of opportunity for small firms to develop niches, the cost of developing new technology in certain key areas is growing so high that only large firms have the financial resources to compete.

Manufacturing expertise and infrastructure - Established firms have in place the manufacturing facilities, in-house expertise and network of subcontractors that are often important advantages in Japan's highly competitive markets. Beyond this, however, there is an even bigger advantage for large, established firms and a barrier for start-ups. American markets with a strong venture capital component are often horizontally organized (firms produce basic, intermediate or final goods but rarely all three). In contrast, Japanese markets are generally centered around a relatively small number of large, vertically integrated companies. Matsushita Electric Industrial Co., Ltd., for example, produces a full range of electric and electronic components as well as the final products that incorporate them. Not only does this make them tougher competitors, but it often concentrates state-of-the-art manufacturing facilities in their hands. In the United States a small start-up venture can contract with a top-flight manufacturer to produce its innovative goods, but a Japanese entrepreneur cannot or will not contract out such work, since the only available contractor is often his largest competitor. The same problem exists when a firm is trying to buy leading-edge components or equipment -- the only source is often the biggest competitor. Even in American markets that are dominated by large firms, such as the pharmaceutical industry, the more fluid U.S. labor market allows start-ups to hire away first-class researchers and manufacturing workers. A capable manufacturing base can be quickly assembled, meaning this kind of barrier to market entry is lower in the United States than in Japan.

Distribution/service network - In Japan it is not always true that if you build a better mousetrap the world will beat a path to your door. Distributing your product around the country and getting space on merchants' shelves

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is a labyrinthine exercise in Japan, and one that favors firms with established brand names and personal contacts. After-sales service, a critically important factor in areas like computers and other advanced machinery, is another major challenge for small firms. It takes a great deal of time and money to set up a distribution/service network, two commodities venture businesses usually have in short supply.

Access to financing - Even though the over-the-counter market was liberalized and modernized in 1984 to bring it up to par with its U.S. counterpart, it is still an ugly duckling in the eyes of most investors (see Table 1). Taking a company public, therefore, remains a difficult way for backers and entrepreneurs to recoup their investment. Since this is a major incentive for venture capitalists, the restrictive attitudes keep a lid on the market's growth.

Table 1: Initial Public Offerings in Japan, 1980-88

(in number of cases)

	1980	1981	1982	1983	1984	1985	1986	1987	1988*
Stock Exchange	11	22	22	26	19	26	36	45	60
Over-the-Counter	14	4	6	6	10	15	22	19	40
Total	25	26	28	32	29	41	58	64	100

*Estimated

Source: Venture Japan

Labor - The task of finding skilled management and labor willing to participate in a start-up is as difficult as ever. Although it is showing some signs of erosion, the lifetime employment system followed by large firms means that the most talented labor is often unavailable to start-ups.

The upshot of all these factors was that business became increasingly difficult for many start-ups in the mid-1980s. The archetypal case is Sord Computers Co., Ltd. After being heralded as the Apple Computer Inc. of Japan, the company came close to bankruptcy before being bailed out by Toshiba Corp. The heaviest casualties were in computer hardware, robotics and semiconductor manufacturing equipment, all fields where capital intensity favors large firms.

If venture businesses fail, investors naturally must share in the pain. But the problems start long before then since investors have to contend with poor showings in initial public offerings. The trading "themes" that sweep Japanese markets played havoc with carefully prepared IPOs. Since an IPO can take several months to prepare while a "theme" can sweep the market within a day and usually lasts less than two weeks, it is easy to see the difficulties involved in gauging the public response to a small company's first offering. Although hard data are scarce, most Japanese venture capital firms will admit that they suffered losses in the 1985-87 period. Japan Finance Co., Ltd., for example, reported that 25 of its investments in the computer and other high technology fields went belly up in 1985.

The Climb Back

Chastened but undaunted, the Japanese venture capital industry is beginning to climb out of its recession. The flood of household savings and corporate profits that has made Japan into a major financial center seemingly overnight has spilled over into the venture capital field. Corporate and individual investors, now more conscious than ever of the relative rates of return on their money, are including venture capital funds or the stock of start-up companies in their portfolios. Venture capital firms linked to banks or securities companies have participated in the financial industry boom and have replenished their investment pools (see Table 2). Stung by their losses in the 1985-87 period, however, venture capitalists are focusing on the service sector in search of fertile ground.

Table 2: Top Japanese Venture Capital Companies

(in billions of yen, as of March 31, 1987)

Company	Founded	Major Stockholder	Total Invested
Japan Associated Finance Co., Ltd.	1973	Nomura Securities Co., Ltd.	Y66.1
Nippon Investment Finance Co., Ltd.	1982	Daiwa Securities Co., Ltd.	19.2
Tokyo Small Business Development Co., Ltd.	1963	Semi-public	16.6
Osaka Small Business Development Co., Ltd.	1963	Semi-public	15.5
Yamaichi Univen	1982	Yamaichi Securities Co., Ltd.	10.4
Nippon Enterprise Development Co., Ltd.	1972	Long-Term Credit Bank of Japan, Ltd.	10.2
Tokyo Venture Capital, Inc.	1974	Dai-Ichi Kangyo Bank, Ltd.	9.1
Nikko Venture Capital, Inc.	1983	Nikko Securities Co., Ltd.	9.0
Sanyo Finance Co., Ltd.	1982	Sanyo Securities Co., Ltd.	9.0
Nagoya Small Business Development Co., Ltd.	1963	Semi-public	8.9

Source: Venture Japan

According to one of Japan's major newspapers, 31.5 percent of venture capital companies surveyed put more money into service-oriented firms in 1987 than the year before. Another 33 percent indicated that the service sector presented the best investment opportunities. The relatively low capital requirements to launch a service business and the usually simple labor requirements make service firms less susceptible to the problems manufacturing companies face. The keys to success in services are creativity and innovation, not brute capital. Service firms also represent 70 to 80 percent of the firms already listed on the over-the-counter market, making it easier to gauge public sentiment since they have an established track record.

This trend toward services also reflects shifting economic conditions: Japan's new affluence, the effort to base growth on domestic demand and the

aging of society. The workaholic Japanese suddenly are turning to leisure activities with a vengeance. The success of Tokyo Disneyland, the proliferation of resorts and the surge in Japanese touring overseas all indicate a ready demand for leisure services. Personal services, such as beauty salons, pet shops and self-improvement courses, are also growing in popularity. Education remains a top priority and the growth of special schools, training courses and other educational aids (computer-aided instruction, for example) has been steady and strong. The rapid expansion of food and retailing franchises is another bright spot that is attracting interest from venture funds. Health and nursing services are also seen as growth industries as the number of senior citizens continues to grow.

The scarcity of other investment opportunities also is pushing venture capitalists toward the tertiary sector. Even though the return on these investments is rarely spectacular, service start-ups are viewed as options with clear growth potential. This does not mean that high technology investments will be abandoned altogether, but services clearly will play a larger role for at least the next several years.

Venture Capital Flows

In view of the deregulation of Japan's financial markets and the increasing Japanese presence in global finance, the growth of venture capital flows into and out of Japan would seem a natural development. Unfortunately, little progress has been made since JEI's 1984 report, particularly in terms of foreign activity in the Japanese market. Although Japanese overseas activity has increased, it remains comparatively small.

The landscape for foreign venture capital in Japan has hardly changed since 1984 with around a dozen foreign companies operating. Some have plunged in and invested directly in Japanese start-ups on an independent basis. Most, however, have taken a more passive attitude by supporting deals organized by others. The foreign firms' chief difficulty undoubtedly arises from their position outside the network of personal contacts, which are the best sources of information on new companies in Japan. Foreign venture capitalists may bring more refined analytic and management skills to the Japanese market, but they often are beaten to the deal-making punch by established Japanese rivals. The fact that foreign investors are often willing to accept more risk has not helped them quickly penetrate the Japanese market. Foreign firms will need more time to become accepted in the Japanese community. Once accepted they will more easily attract and win the business of Japan's growing group of entrepreneurs.

Japanese venture capitalists themselves are stymied by a dearth of opportunities at home and have been trying to expand overseas operations. The appreciation of the yen has accelerated this trend. According to a private survey, a cumulative total of nearly Y9 billion ($72 million at Y125=$1.00) in venture funds had moved out of Japan through March 31, 1987 (see Table 3). Most of the activity has been in the United States, according to that same survey, although an exact percentage was not mentioned. Overseas investments generally are handled by a Japanese subsidiary; rarely do the parent companies invest directly on their own. A major function of these overseas offices is to provide a conduit for American and Japanese firms to arrange strategic alliances and promote technology transfers. The subsidiaries are also on the lookout for new Japan-related investments in which to participate.

Table 3: Top Overseas Venture Capital Investors

(in millions of yen, as of March 31, 1987)

Company	Major Stockholder	Total Invested
Kangyo Kakumaru Investments	Nippon Kangyo Kakumaru Co., Ltd.	Y1,762.5
Tokyo Venture Capital, Inc.	Dai-Ichi Kangyo Bank, Ltd.	1,575.0
Yamaichi Univen	Yamaichi Securities Co., Ltd.	1,062.5
Japan Associated Finance Co., Ltd.	Nomura Securities Co., Ltd.	1,050.0
TechnoInvestment Inc.	TechnoVenture Inc.	987.5
Nippon Enterprise Development Co., Ltd.	Long-Term Credit Bank of Japan, Ltd.	875.0
Nippon Investment Finance Co., Ltd.	Daiwa Securities Co., Ltd.	575.0
Oriental Capital Co., Ltd.	Oriental Leasing Inc.; Hambrecht & Quist; Baring Brothers, Ltd.	375.0

Source: Venture Japan

Asia is attracting an increasing amount of investment attention, particularly some of the newly industrialized economies. Taiwan and Hong Kong are well suited for venture capitalists with their numerous small, innovative and flexible companies. Although South Korea and Singapore do not have the same factors going for them, Japanese venture capital firms are establishing funds and developing contacts in these countries as well. The progress of China's economic reform program is being watched carefully by investors. Although joint ventures are encouraged by Beijing, the most desired foreign partners are large, established manufacturing firms. Some tentative moves are being made to attract venture capital in light industry, but investors are extremely cautious given the difficulties previous joint ventures have encountered.

As for other parts of the world, India and Europe are areas of current interest. Japanese direct investment in Indian manufacturing facilities has increased in recent years. The concept of the entrepreneur and venture capital is well established there, creating a conducive atmosphere for Japanese investors. In Europe, the resurgence of small high technology firms is attracting renewed Japanese interest, particularly in Great Britain. Spain and Portugal also present new opportunities thanks to their membership in the European Community and their relatively low wage rates.

In general, however, Japanese venture capitalists are just beginning to test the international waters. In tried-and-true Japanese fashion, they can be expected to adopt a cautious, incremental approach to penetrating foreign markets. From a global perspective, this may be unfortunate since the United States, as the world's top debtor nation, can be expected to reduce its high-risk foreign lending. Unless Japanese investors take up the slack, global growth may suffer.

Government's Helping Hand

In 1984 Tokyo was entranced with the concept of venture capital. General concerns focused on finding sources of innovative ideas and products as the economy evolved beyond the mass-production/mass-consumption stage. Venture businesses seemed to generate a large share of the new products and services in the United States, and Tokyo clearly hoped to replicate this function in Japan. Central and local governments established venture capital funds and tried to improve the general business atmosphere for start-ups. The Ministry of Finance's financial liberalization program, while not specifically aimed at venture capital, was expected to alleviate the critical finance problems facing entrepreneurs and investors alike. The internationalization of Japan's financial and goods markets was supposed to energize the venture capital market as well.

Unfortunately, Tokyo's hopes proved too optimistic. A financial system that developed over three decades could not be overhauled in a few years. The system's bias toward lending to large corporations remained strong. While the Tokyo Stock Exchange has experienced an unprecedented boom in the past several years, the over-the-counter market has enjoyed only moderate growth. Small companies are unable to take advantage of the Euroyen and other offshore markets or the commercial paper market. In fact, small businesses have received relatively little direct benefit from the government's financial liberalization and internationalization programs.

Nevertheless, a number of government policies, mostly administered by the Ministry of International Trade and Industry, are directed specifically at high risk, high technology small businesses:

Technopolis - MITI's long-range plan to develop centers where academic and industrial researchers can pool their efforts is proceeding pretty much as planned. The program provides low-cost land, roads, utilities and other infrastructure in an attempt to attract high technology firms to cities around the country. There are 26 Technopolis centers under development with another handful in the planning stage. The program has so far been quite successful, but doubts remain about the long-term viability of all Technopolis areas.

Japan Key Technology Center - This organization's main mission is to cofund long-term private joint research and development projects involving technologies vital to future economic growth. Since its creation by MITI in October 1985, the center has selected more than 50 projects for a total investment of Y4 billion ($32 million). Many of these projects include venture companies, but large firms also have taken advantage of the program. Foreign firms were expected to participate, but so far the response has been meager.

Technomart - This loosely structured organization was meant to function as a clearinghouse for entrepreneurs with ideas and investors with money. Since its inception in 1985, few details have been released about its operations. Its success may be assumed since funds continue to be appropriated for it.

Venture Enterprise Center - The VEC continues to act as a modest source of low-cost loans for small businesses meeting certain managerial and product-oriented requirements. Although created in 1975, the VEC began to have an impact only in the 1980s. With an emphasis on guaranteeing loans rather than actual lending, the VEC has aided more than 500 small businesses through the

end of fiscal 1987 (March 31, 1988). Although the spread between its guaranteed loan rates and regular commercial rates has narrowed, VEC loans remain attractive.

Research Core Program - This project, the only recent addition, is very similar to the Technopolis program. A total of 33 projects is currently envisioned, centering on a wide range of subjects, including energy, biotechnology and integrated communications. Many of these research cores are actually associated with existing Technopolis developments. This program is more focused than the Technopolis plan, however, because it provides specific funding for research activities, not just low-cost infrastructure. Like the Technopolis program, research cores are meant to give businesses an initial boost. Development is expected to snowball and advance under its own momentum without further government aid as other companies are attracted to the initial activities.

Government policy, therefore, remains aimed at creating environments in which venture capitalists and entrepreneurs enjoy enhanced chances for success. Direct involvement in promoting the venture capital industry is very limited, perhaps due to the realization that central guidance could snuff out the very creativity and innovation that is desired. Nevertheless, Tokyo feels that venture capital will play a key role in keeping the economy dynamic and vital.

Benchaa Kapitaru

It is clear that Japan's venture capital industry is developing in a unique fashion, contrary to nearly everyone's hopes. Given the differences between the financial, industrial and regulatory structures of the United States and Japan, this unique path is hardly surprising. Japan's venture capital industry appears to exhibit four special attributes in its current incarnation:

- The time lapse between establishment of the venture and its initial public offering is long compared to the American average of five years. Before 1970 the gestation period was as long as 15 years; Sony Corp., for example, was incorporated in 1946 but offered its first public issue in 1958. The average shrank somewhat to around 10 years for firms established in the 1970s. CSK Corp., a computer consulting firm, is typical: it was founded in 1968 and went public in 1977. Data on ventures launched this decade are still inconclusive, although it appears that the average interval may have fallen again. This phenomenon reflects the difficulty of establishing a company's reputation in Japan. Stung by the 1982-85 economic slowdown, when many IPOs by firms less than five years old failed, investors are likely to seek proof of sustainability, thus contributing to a longer average interval for ventures going public.

- Investments in start-ups are not the sole, or even main, reason for establishing a venture capital company. Since most venture capital firms are linked to a bank or a securities company, they often serve more as a means of developing new clients for the main business rather than as an end in themselves. Some bank-related companies, for example, have arranged loans worth approximately twice as much as their direct investments. This pattern has tended to blunt the aggressiveness of Japanese venture capital firms at home and abroad.

- Possibly related to this, Japanese venture capital firms seem to prefer low-risk deals in comparison with their American counterparts. Since

the clients of venture capital firms often establish more traditional business relationships with the parent bank or securities company, they must meet the minimum requirements set by the parent. This naturally forces investors to shy away from investments an American venture capitalist would not hesitate to back.

- Japanese investors' lack of involvement in the management of start-up businesses contrasts sharply to the American situation. An American venture capitalist most often actively provides whatever expertise he has to offer -- an offer gladly accepted by entrepreneurs, who would rather focus their talents on creating and innovating. In Japan it requires a dire situation before the investor will step in. This actually breeds resentment and distrust between investors and entrepreneurs, even if the entrepreneurs could benefit from the advice.

From Venture Capital to New Business

Japan's venture capital industry remains immature, despite more than a decade of development. While younger Japanese may be personally suited to venture business as it is known in the United States, the Japanese economy may not be. In its drive to become the world's most efficient mass producer of consumer and industrial goods, the Japanese economy left very little room for small, independent companies to make a significant contribution. Financial and human resources were funneled to major Japanese corporate groups; small businesses were left to play a supporting role. The economy in the 1980s is subject to new forces and is clearly in transition. In keeping with the times, the term "venture capital" is now rarely used in the Japanese press. To avoid a high technology connotation, the term "new business" has been adopted to expand the new characterization of venture capital in Japan.

Economic restructuring is the latest buzzword in Japan, referring to an effort to make domestic demand the main driving force of growth and reduce reliance on the external sector. This trend presents both opportunities and threats for venture capital. On the one hand, Japanese consumers are focusing on the quality of life and paying a good deal of attention to leisure and personal services, as mentioned previously. Most Japanese observers expect both the young and the old to demand a growing number of services, providing a ready market for many new businesses.

On the down side, restructuring is forcing many firms in mature markets to diversify into new areas, including services and high technology. Perhaps the clearest examples of this are Nippon Steel Corp. and the Japan Railways Group (the ex-Japanese National Railways). The world's largest steel maker is pursuing an aggressive diversification program to reduce dependence on its traditional business. On April 1, 1988 it established four joint ventures in the communications and information processing fields. The JR group has chosen to move into food and dry goods sales (a chain of coffee/snack shops has been opened in or near many railroad stations) in addition to communications and transportation. The entry of such giants into areas of intense new business activity is raising fears of a repeat of the problems that hit start-ups in the high technology manufacturing field.

The strong yen has proved to have a relatively small impact on venture businesses since most were not geared toward the export market. In fact, most are overjoyed at the prospect of greater domestic spending by the government

and consumers. Some have even moved boldly into the importing business in an effort to capitalize on the yen's strength. Venture investors certainly have been buoyed by the yen's strength, and interest in overseas investments is growing.

The impact of the global stock market crash last October is still being sorted out. While the Tokyo Stock Exchange index has erased the loss, the market is still edgy. The prolonged boom may yet spur a new rash of IPOs, but there is no guarantee that the reception will be any warmer than before. A scandal involving possible price fixing of new issues has just shaken the OTC market and made it an uncertain bet at best for IPOs in the near future. The OTC market may become increasingly attractive to small- and medium-size investors, however, if the TSE climbs to unaffordable heights.

The government's continued programs of financial liberalization and deregulation represent venture capital's greatest hope and problem. If tax and financial regulations were radically liberalized and changes took place in the labor market and distribution system, an American-style venture capital industry might have a chance to evolve. Since such liberalization is unlikely, however, Japan's venture capital industry must continue to find its own path and its own place in the economy and society.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.